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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 264

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PAN-AMERICAN LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 34–55) is reported in 38 B. T. A. 1430. The opinion of the Circuit Court of Appeals (R. 84–89) is reported in 111 F. (2d) 366.

JURISDICTION

The judgment of the United States Circuit Court of Appeals was entered April 20, 1940 (R. 89). Petition for certiorari was filed on July 20, 1940,

and was granted on October 28, 1940. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether reserves required by state laws to be maintained by a life insurance company for the payment of incurred disability benefits under policies of combined life, health, and accident insurance constitute "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 7–13.

STATEMENT

From the findings of the Board of Tax Appeals the following material facts appear:

The petitioner is a life insurance company incorporated under the laws of the State of Louisiana, and during the tax year 1933 transacted business in the States of Louisiana, Oklahoma, Indiana, and Illinois (R. 36).

More than fifty percent of the petitioner's total reserve funds held during the tax year 1933 were held for the fulfillment of its life insurance and annuity contracts (R. 36).

Among the life insurance policies issued by the petitioner during the year 1933 were certain pol-

icies which carried additional provisions relating to certain noncancellable benefits in case the insured became totally and permanently disabled by accident or disease. These noncancellable benefits, for which in each case the insured obligated himself to pay an additional premium, were of two kinds (R. 36):

(1) Waiver of premiums by the petitioner in case of the insured's total and permanent disability; and

(2) Both waiver of premiums and payment by the petitioner to the insured of a monthly income in case of his total and permanent disability.

The petitioner at the beginning and end of the tax year 1933 maintained a "reserve for incurred disability benefits," representing unpaid and unresisted claims incurred under the above disability provisions of the respective policies as follows (R. 38):

	Beginning of year	End of year
Reserve for premium waiver benefits	$93,375.27	$113,674.60
Reserve for monthly income benefits	217,875.64	265,240.76
Total	311,250.91	378,915.36

NOTE.—The mean of the above reserve amounts to $345,083.13, and 3¾ per centum thereof equals $12,940.62.

The purpose of the reserve for incurred disability benefits is to enable petitioner to pay the benefits where the disability has already occurred, but where such benefits have not yet become due. It is based

upon a table which shows the rates of death and recovery from disability, described as "Hunter's Rate of Termination of Disability on Disabled Lives." The reserve is computed by determining the present value of the probable future benefits. This is done by discounting the probable future benefits (either the waiver of premiums or both the waiver of premiums and the payment of a monthly income) at 3½ per centum compound interest, and adjusting that amount with the aid of Hunter's table by taking into account the probability of the insured living and still being totally and permanently disabled on the premium due date. The reserve for incurred disability benefits is set up only on those policies where the insured has already become totally and permanently disabled, and the waiver of premiums, or both the waiver of premiums and the payment of a monthly income, depending upon the type of policy, is subject in all cases to the continuance of such disability (R. 38-39).

The "reserve for incurred disability benefits" held by the petitioner at the beginning and end of the tax year 1933 was required by the laws of the States of Oklahoma and Illinois, two of the states in which the petitioner did business (R. 39-40), and the source of the reserve was premium payments and income from investments thereof (R. 40).

The Board held that the petitioner's so-called reserves for incurred disability benefits constituted

"reserve funds required by law" within the meaning of the federal statute, and the Circuit Court of Appeals affirmed the Board's decision.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding and deciding that the reserves held by the taxpayer at the beginning and end of the calendar year 1933 for "incurred disability benefits" constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

2. In holding and deciding that the reserves maintained by the taxpayer at the beginning and end of the calendar year 1933 for "premium waiver benefits" constituted "reserve funds required by law," within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

3. In holding and deciding that the reserves maintained by the taxpayer at the beginning and end of the calendar year 1933 for "monthly income benefits" constituted "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932.

4. In affirming the decision of the Board of Tax Appeals.

ARGUMENT

The question whether reserves required by state laws to be maintained by a life insurance company for the payment of disability benefits under policies

of combined life, health, and accident insurance constitute "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932 is discussed in Point II of the Government's brief in *New World Life Ins. Co.* v. *United States,* No. 2, present Term, to which reference is hereby made.

It may be noted that the *New World* case involves reserves for so-called "Active Lives" as well as "Disabled Lives," whereas the instant case involves only reserves comparable to the "Disabled Lives." And we contend in the *New World* case that even if deductions are generally allowable with respect to reserves for health and accident insurance, they should not be allowed where the disability has already occurred.

CONCLUSION

The judgment of the court below should be reversed.

Respectfully submitted.

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NOVEMBER 1940.

APPENDIX

The pertinent provisions of the Revenue Act of 1932, c. 209, 47 Stat. 169, 223–227, pertaining to the tax on life insurance companies read as follows:

SUPPLEMENT G—INSURANCE COMPANIES

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.—(a) *Definition.*—When used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

* * * * *

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.—(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * * *

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.—(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) *Reserve funds.*—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption

rate, the rate of 3¾ per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, shall be allowed, in addition to the above, a deduction of 3¾ per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

* * * * *

Article 971 of Treasury Regulations 77, as originally promulgated, provided as follows:

ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four percent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ percent shall be substituted for 4 percent. The reserve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the State insurance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance. * * * Reserves maintained to

provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, but the reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7–11 of the liability page of the annual statement for life insurance companies, and items 16–19 and 26 of the liability page of the annual statement for miscellaneous stock companies, if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered.

Article 971 of Treasury Regulations 77, as amended by Treasury Decision 4615, XIV–2 Cum. Bull. 310, 312, approved December 18, 1935:

ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four percent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ percent shall be substituted for 4 percent.

In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; annual and deferred dividends; accrued but unsettled policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the

return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

* * * * *

The pertinent provisions of the statutes of the State of Oklahoma, Oklahoma Statutes (1931), Vol. 2, c. 51, Art. 1, provide as follows:

10501. *Annual calculations of obligations of life companies.*—The insurance commissioner shall annually make calculations of all outstanding policies, additions thereto, unpaid dividends, and all other obligations of every life insurance corporation doing business in this State. All valuations made by him, or by his authority, shall be made upon the net premium basis. The legal minimum standard for valuation of contracts issued before the first day of January, nineteen hundred and ten, shall be the actuaries or combined experience table of mortality, with interest at four percent per annum, and for valuation of contracts on or after said date, shall be the American experience table of mortality, with interest at three and one-half percent per annum. The commissioner may vary the standards of interest and mortality in the case of corporations of foreign coun-

tries as to contracts issued by such corporations in other countries than the United States, and in particular cases of invalid life and other extra hazards; and value policies in groups, use approximate averages for fractions of a year and otherwise, and accept the valuation of the department of insurance of any other state or country, if made upon a basis and according to standards not lower than herein required or authorized, in place of the valuation herein required.

10502. *Funds must equal liabilities—Violation—Penalty.*—When the actual funds of any life insurance company doing business in this State, exclusive of its capital, are not of a net cash value equal to its liabilities including the net value of its policies according to the basis and minimum standards prescribed or authorized by the laws of this State, it shall be the duty of the insurance commissioner to give notice to such company and its agents to discontinue issuing new policies within this State, until such time as its funds have become equal to its liabilities as aforesaid. * * *

The pertinent provisions of the statutes of the State of Illinois, Illinois Revised Statutes (1935), c. 73, ¶ 331, provide as follows:

¶ 331. *Assets less than liabilities—Notice to company—Failure to make a deficit good—Penalty for issuance of policy—Annual valuation of outstanding policies, etc.—Term insurance—Reserve—"Premium payment period" construed.*

§ 10.

* * * * *

The Department of Trade and Commerce shall annually make valuations of all outstanding policies, additions thereto, unpaid

dividends and all other obligations of every life insurance corporation doing business in this State. All valuations made by it or by its authority shall be made upon the net premium basis. The legal minimum standard for valuation of contracts issued before the first day of January, 1908, shall be the Actuaries' or Combined Experience Table of Mortality with interest at 4 per centum per annum and for valuation of contracts issued on or after said date shall be the American Experience Table of Mortality with interest at 3½ per centum per annum. The Department of Trade and Commerce may vary the standards of interest and mortality in the case of corporations from foreign countries as to contracts issued by such corporation in other countries than the United States, and in particular cases of invalid lives and other extra hazards; and value policies in groups, use approximate averages for fractions of a year and otherwise, and accept the valuation of the department of insurance of any other state or country if made upon the basis, and according to the standards not lower than herein required or authorized, in place of the valuation herein required.

* * * * * *

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